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In The Supreme Court of The United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF OF AMICUS CURIAE

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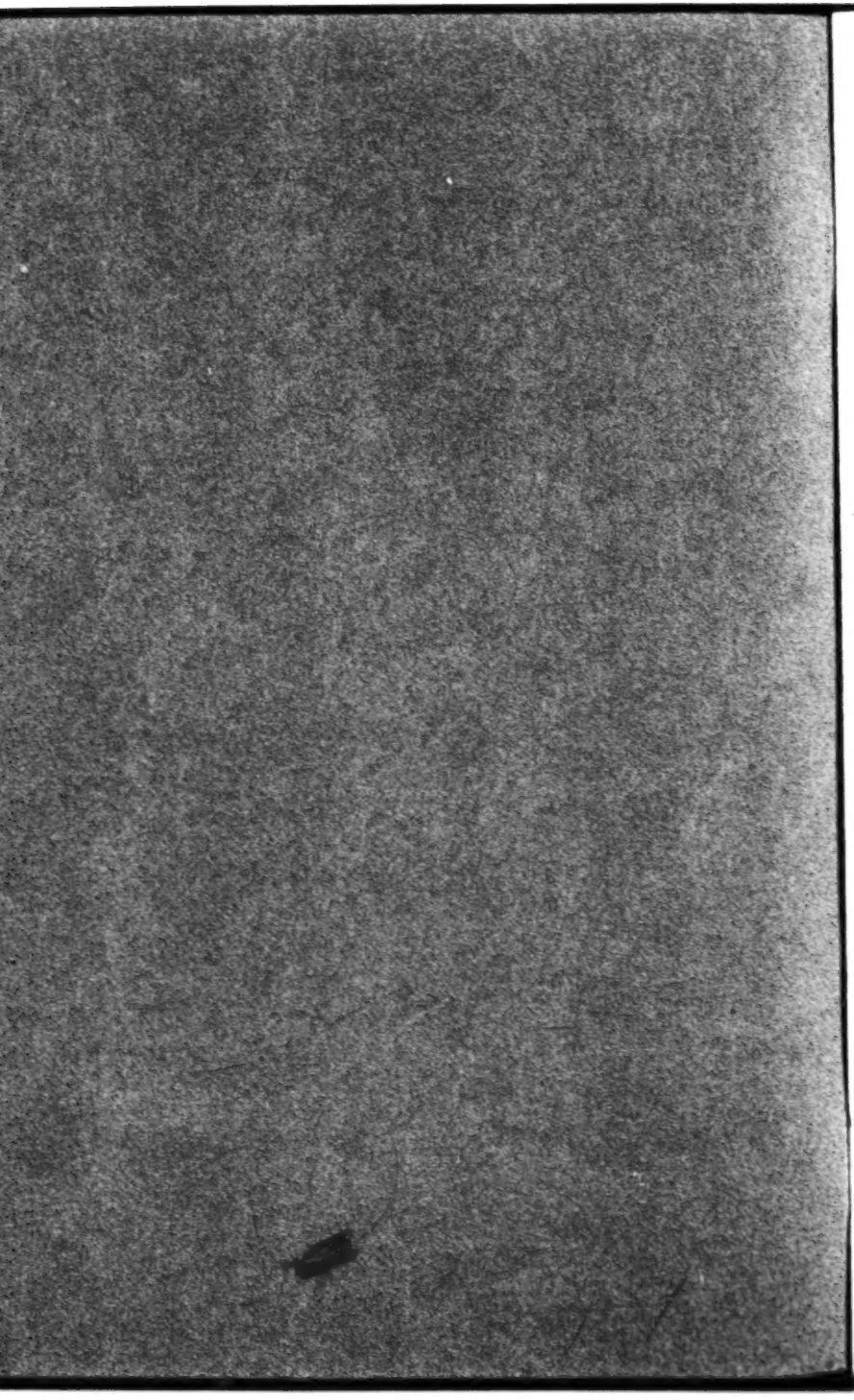

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STATEMENT OF INTEREST

The Fed-Mart Corporation ("Fed-Mart") deducted on its Federal Income Tax Return for its fiscal year ended September 3, 1967, bond discount expense of $87,750.77 which resulted because of Fed-Mart's exchange in 1967 of $2,835,900.00 principal amount of its 6-12% junior subordinated debentures, dated February 1, 1987, for 226,872 shares of its outstanding common stock. Fed-Mart deducted $87,750.77 as a bond discount expense under Section 163 of the Internal Revenue Code and Regulation Section 1.163-3 (b) (1) on its Federal Income Tax Return for its fiscal year ended September 3, 1967. Upon audit, this deduction was disallowed.

The total tax alleged to be owed by the Internal Revenue Service was $673,206.11. A timely claim for refund was filed on or about December 1, 1972, with the Internal Revenue Service Center, Fresno, California, in the amount of $42,120.37, together with assessed interest in an amount of $12,649.95, plus any other amount which was legally refundable.

Fed-Mart received a notice dated March 29, 1973, stating that its claim for refund was disallowed in full.

On June 8, 1973, Fed-Mart filed a Complaint in the United States District Court, Southern District of California, as plaintiff against the United States of America as defendant for the recovery of Internal Revenue Service taxes praying that judgment be entered in its favor for $54,770.32, together with interest as provided by law.

The Department of Justice, by its attorney Robert Livingston, has filed an Answer praying that judgment be entered in its favor, dismissing Fed-Mart's Complaint with prejudice and granting the United States its costs. The case is now at issue.

Similar claims for refund involving the same exchange and deduction of bond discount have been filed regarding Fed-Mart's fiscal years ended September 1, 1968, August 31, 1969, and August 30, 1970.

PURPOSE AND APPROACH OF BRIEF

The purpose of this brief is to present a common sense and simplified approach, analysis, and solution to the question whether bond discount may arise when a corporation exchanges its debenture for its previously issued and outstanding stock. The argument and examples relate to transactions occurring before May 27, 1969 (the effective date for the change in Section 1232 of the Internal Revenue Code).

The approach is predicated upon accepted law that bond discount is interest, even though unstated or deferred, which is deductible exactly the same as stated interest under Section 163 (a) of the Internal Revenue Code of 1954.[1] The approach contained herein argues that unstated interest on indebtedness, as well as stated interest, is deductible without regard to the reason or manner in which the indebtedness was incurred.

ARGUMENT

Bond Discount is Interest Expense.

The starting point for analysis should be the simplest example possible where it is clear that bond discount is deferred interest. The Government in its brief uses the following example:

> "The prototype transaction where discount arises is one where a corporation receives

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[1] Treasury Regulation Section 1.163-1 (a) (1); Internal Revenue Code Section 163 (a).

> $950.00 upon the issuance of its bond in the face amount of $1,000.00, payable ten years after issuance. While the bond may have a stated annual interest rate of 5% so that the holder receives $50.00 per year, the $50.00 difference between the issue price ($950.00) and the face amount ($1,000.00) represents an additional cost to the corporation for the use of money of $5.00 per year over the ten-year life of the bond. Accepted accounting practice treats discount as deferred interest."[2]

In the above example, the difference between the issue price and the face amount is deferred interest which the corporation must pay to the bond holder at the maturity date. Such deferred interest is amortizable over the life of the bond.

The amount of the deferred interest will vary depending upon the interest rate of the bond as the issue price of the bond varies with the interest rate. As the stated interest rate decreases, the issue price of the bond will decrease, and conversely, if the stated interest rate increases, the issue price will increase. For example, a corporation may be able to receive $950.00 for a $1,000.00 bond bearing a 5% interest rate whereas it may only be able to receive $900.00 for a $1,000.00 bond bearing a 3% interest rate. In either case, the amount by which the face amount of the bond exceeds its issue price is an additional interest expense.

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[2] Petitioner's Brief, page 10.

Moving to the next example, suppose that instead of receiving cash for its bond, a corporation received property which was not its own stock. In this case, the discount would still be the excess, if any, of the face amount of the bond over the fair market value of the property on the date of the exchange. The sole difference in this example is that instead of receiving cash, the corporation received property, the fair market value of which is used for determining the amount of the unstated interest or bond discount.

The next question is whether bond discount may arise if the corporation received its own stock in exchange for its bond. The Government argues in its brief that in order for bond discount to arise in this case, there must be an acquisition of property.[3] This statement is irrelevant. The question is not whether there is an acquisition of property, but simply whether there is deferred interest on an incurred indebtedness. Why the indebtedness is incurred or what the corporation received for the indebtedness is irrelevant, provided the debt is bona fide. Interest is deductible under Section 163. Unstated or deferred interest is also deductible under Section 163 in the same manner as stated interest. Since the issue price of the bond varies with the stated interest rate, the amount of the stated interest rate is one factor in determining the interest expense arising from the obligation. The fact that property is or is not acquired is meaningless so long as there is a bona fide indebtedness incurred and there is interest on the debt. No one has or can argue that the stated interest rate is not deductible by the respondent corporation. Therefore, as the stated interest rate is only one factor in the determina-

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[3] Petitioner's Brief, pages 19-26.

tion of interest expense, the amount by which the face amount of the bond exceeded its fair market value (issue price) at time of issuance must also be taken into consideration in determining the entire interest cost.

In Deputy v. duPont, 308 U.S. 488, 498, this Court interpreted the term "interest on indebtness" to mean "compensation for the use or forbearance of money." The actual interest rate on the $50.00 bond is "compensation for the use or forbearance of money" as this Court has interpreted the term "interest on indebtedness." The unstated or deferred interest in this case, like the stated interest, is part of the forbearance of money -- i.e., instead of the corporation paying the debt or bond principal currently, it has agreed to pay interest and part of the interest is deferred to the date the bond matures. Simply stated, bond discount is deferred or unstated interest on an indebtedness which may be amortized over the term of the indebtedness and deducted under Section 163 of the Internal Revenue Code of 1954. The key is bona fide indebtedness, not the reason the debt was incurred or the type of consideration received except for the purpose of determining the unstated interest on the debt.

Interest Expense May Arise Even in a Recapitalization.

Likewise, the Government's argument and the position of the Internal Revenue Service[4] that there can

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[4] Petitioner's Brief, pages 14-19; Revenue Ruling 59-387, 1959-2 Cum. Bull. 56.

be no bond discount in a readjustment of the corporation's own securities in a form of recapitalization because there is no loss, is incorrect. Bond discount is not deductible because a corporation incurred a loss, but simply because the bond discount is unstated interest.

The Government argues in its brief that "in order for bond discount to arise, there must be an outlay or an obligation to make an outlay, in excess of the original capital borrowed."[5] Although this statement standing alone may be correct, it must be analyzed with reference to stated interest. Since bond discount is interest, even though unstated, the statement quoted applies equally to stated interest -- i.e., in order for stated interest to arise, there must be an outlay or an obligation to make an outlay in excess of the original capital borrowed. First, no one has or can argue that stated interest is not deductible and, therefore, there must have been an obligation to make an outlay in excess of the original capital borrowed. On the same principle, unstated interest would also meet the test. Second, the fundamental question is the issue price of the bond. If the issue price is less than the face amount of the bond, there is by definition an obligation to make an outlay ($50.00) in excess of the original capital borrowed (the issue price of the bond). It must be kept in mind that in order to be entitled to a deduction for stated interest, all that need be present is an indebtedness. A corporation can create debt in any manner it chooses even by acquiring its own stock and substituting its debt obligations. The unstated interest on the debt obligation is deductible as is stated interest.

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5 Petitioner's Brief, page 13.

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5 Petitioner's Brief, page 13.

The Original Issue Price of the Stock is Irrelevant.

The next issue is whether it is relevant that the corporation which issued the bond had received consideration equal to the face value of the bond when the stock it received in the exchange was originally issued. This fact is irrelevant if the sole issue is whether there is unstated interest on the debt. The discount has nothing to do with the nature of the property received in the exchange except to determine the amount of the unstated interest. An approach which takes into consideration the nature or value of the property originally received for the stock is viewing a bond discount as a loss. It is not a loss -- it is interest.[6] The original issuance of the stock was a closed transaction. The issuance of the bonds was a separate transaction in which the corporation incurred a debt plus an obligation to pay stated and deferred interest thereon. The reason or manner in which a bona fide debt is incurred is irrelevant under Section 163.

The Evidence Indicates that the Issue Price Was Less than Face Value.

The basic issue in this case is the issue price of the bonds. If it is less than the face amount, there must by definition be bond discount.

The Government has argued in its brief that "there is nothing to suggest that respondent was paying more than the stated rate of 5% as compensation for the use

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6 U.S. v. Midland-Ross Corp., 381 U.S. 54; see Petitioner's Brief, page 12.

or forbearance of money . . . "[7] However, this argument merely strengthens the position set forth herein that if it is found as a fact that an issuer is paying more than the stated rate (however determined), then there is additional interest expense. And, contrary to the Government's position, there is sufficient evidence to sustain a holding that the issue price in the instant case was equal to $33.00 per bond (the indicated fair market value of the preferred stock received in exchange). Therefore, respondent was, in fact, paying more than the stated interest rate.

In summary, bond discount is unstated interest which should be deductible exactly the same as stated interest. The difference between the issue price of the bonds and the face amount of the bonds is always unstated interest.

CONCLUSION

For the reasons stated herein, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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By: _____
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[7] Petitioner's Brief, pages 18-19.